United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7600

In The

United States Court of Appeals

For The Second Circuit

No. 76-7600

J. P. Foley, Inc., John P. Foley, Jr.,
Anne A. Foley and Anita Salisbury,
Plaintiffs-Appellants,

—against—

New York Stock Exchange, Inc. and
American Stock Exchange,
Defendants-Appellees.

On Appeal From the United States District Court for the Southern District of New York

BRIEF OF DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

Milbank, Tweed, Hadley & McCloy
Attorneys for Defendant-Appellee New York Stock Exchange, Inc.
1 Chase Manhattan Plaza
New York, N. Y. 10005

Of Counsel:
Russell E. Brooks
Edward J. Reilly
Norman R. Nelson

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BRIEF OF DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

This is an appeal from the judgment of the United States District Court for the Southern District of New York (Lasker, J.) entered on December 17, 1976 following a four-week trial before a jury (JA* 23-24). The judgment is based on the jury's verdict in favor of appellee New York Stock Exchange, Inc. (the "Exchange") on the claim that it had violated Section 6 of the Securities Exchange Act of 1934, 15 U.S.C. § 78f. The judgment is also based on the District Court's direction of a verdict at the close of plaintiffs' case in favor of the Exchange and appellee American

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* "JA" refers to the Joint Appendix.

Stock Exchange, Inc. (the "Amex") on a claim based on Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, and in favor of the Amex on a claim based on Section 6 of the Exchange Act.

Issues Presented for Review

1. Did the District Court properly direct a verdict in favor of the Exchange on the ground that the undisputed facts established the lack of a duty of the Exchange to convey information to plaintiffs?

2. Did the District Court properly direct a verdict in favor of the Exchange on the ground that the undisputed facts established that the Exchange had no knowledge of any fraudulent conduct by others?

3. Did the District Court properly direct a verdict in favor of the Exchange on the ground that there was no showing of scienter?

4. Can the Exchange be held vicariously liable as a controlling person for conduct undertaken to perform its regulatory duties on behalf of public customers?

Plaintiffs assert error in the charge to the jury and in the denial of their motion for judgment notwithstanding the verdict (Br.* 2). Since plaintiffs fail to explain these points, it is impossible to respond, and they should be deemed abandoned. In any event, the decision in *Arneil* v. *Ramsey*, Fed.Sec.L.Rep. (CCH) ¶ 95,865 (2d Cir. Feb. 16, 1977), requires dismissal of the Section 6 claims.

Statement of the Case

On April 3, 1970, plaintiffs, acting through John P. Foley, Jr. ("Foley"), made a subordinated investment in Blair & Co., Inc. ("Blair"), a member organization of the Exchange and the Amex. Foley also obtained options to become an equity participant in Blair and in Capital Management Corporation, an affiliate of Blair. This action, commenced on July 2, 1971, seeks recovery of the loss al-

* "Br." refers to the Brief for Plaintiffs-Appellants.

legedly suffered by plaintiffs when Blair went into liquidation in late 1970.

The Section 6 claim was based on allegations that plaintiffs made their investment in Blair in reliance upon the defendants' performance of their duties, imposed by Section 6, to enforce their rules against Blair and that defendants had failed to perform that duty (JA 12-13) and continued to fail to perform that duty (JA 17-18). The Section 10(b) claim alleged that the Exchange failed to disclose material facts to plaintiffs before plaintiffs made their subordinated investment in Blair and that the Exchange knew about false representations made to plaintiffs by Blair, its officers, directors, and independent auditors (Arthur Young & Company), and aided and abetted these false representations (JA 13-17).

Trial commenced on May 24, 1976 and continued until June 17, 1976. On June 9, 1976, after plaintiffs had completed their case, Judge Lasker granted the Exchange's motion for a directed verdict on the Section 10(b) claim and the Amex's motion for a directed verdict on both the Section 10(b) and Section 6 claims. Judge Lasker's reasoning, presaging the later opinions of this Court in *Hirsch* v. *duPont*, Fed.Sec.L.Rep. (CCH) ¶ 96,011 (2d Cir. April 7, 1977), and *Murphy* v. *McDonnell & Co.*, Fed.Sec.L.Rep. (CCH) ¶ 96,021 (2d Cir. April 14, 1977), was that the Exchange had no direct duty of disclosure under Section 10(b) to plaintiffs and that the Exchange "did not fail to disclose to Mr. Foley anything whatsoever, because they made no disclosure to him" (JA 1008). Moreover, the District Court found the proof "totally inadequate to establish the requisite element of scienter as defined by the Court in [*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)]" (JA 1007). The Court found no showing of any intent to manipulate or "recklessness" which "might possibly support a case under 10b-5" (JA 1008). The Court also stated:

> "They [the Exchange] had every right to assume that the firm itself [Blair] would have disclosed to him [Foley] all business facts normal to such a transaction

> and had even more right, it seems to me, to assume that Mr. Foley himself, in making so large an investment as $2.5 million in a firm which he admits he knew was having business troubles, when every person reading the newspapers and paying any attention to the affairs of the Stock Exchange at the time knew that there were serious problems facing Stock Exchange firms, would have asked for [t]he necessary information." (JA 1008)

The issue of the Exchange's performance of its regulatory duty under Section 6 was submitted to the jury at the conclusion of the evidence. The jury returned a verdict in favor of the Exchange.

Statement of Facts

Plaintiffs' statement of the facts (Br. 4-14) is selective and inaccurate. In view of plaintiffs' distortion and disregard of the record, the facts and supporting evidence are set forth in full in this brief.

A. Foley's Investment

Background. Beginning in 1967, brokerage firms were experiencing an unprecedented volume of securities transactions which placed a great strain on the physical ability of brokers to deliver stock certificates to other brokers and to customers and to maintain the accuracy of their record-keeping. These operational or "back office" problems resulting from the high volume of transactions (commonly called the "paperwork crisis") required many brokerage firms to convert to more sophisticated computer record-keeping systems which were very expensive to install and maintain. Many firms also found it necessary to raise additional capital to finance their increased activities and to protect their customers against any risk arising from these operational difficulties.

On top of the paperwork crisis, a financial crisis for brokerage firms began in late 1969. The market value of securities tumbled disastrously from late 1969 through May of 1970, when it began a slow climb back up, not reaching its January 1970 level until January 1971 (E* 422). The

* "E" refers to the Exhibit Volume filed with the Joint Appendix.

decline in securities prices affected both the capital of brokerage firms, which was substantially held in securities, and the profitability of brokerage firms due to the decline of securities held in firm trading and other accounts (JA 589-90). Along with the precipitous drop in securities values, the volume of trading declined so that the commission income of securities firms decreased markedly at the same time that the assets of these firms were also declining severely (JA 590-91).

Foley had been graduated Phi Beta Kappa from Indiana University and had received a Ph.D. in psychology from Columbia University (E 85, 90). As a management consultant, he had advised brokerage houses concerning personnel employment and management problems (JA 108-09) and was aware of the operational and financial difficulties being experienced by brokerage firms (JA 110). He decided that these could be overcome and that profits would return as brokers adopted computer systems for handling security transactions and employed more highly-trained back office personnel (JA 134-37). He said that it was timely to invest in a brokerage house because it was a "turnaround situation" (JA 1160).

Foley was seeking to make an investment of $3 to $4 million on behalf of himself, his wife, Anne A. Foley, his business assistant, Anita Salisbury and J. P. Foley & Co., Inc., the firm of management consultants of which he was president, Mrs. Foley was secretary and Mrs. Salisbury was vice president (JA 29, 1082, E 427). From early 1969 onward, Foley was engaged in negotiations with Hayden Stone Incorporated, a brokerage firm and member organization of the Exchange which was then experiencing capital and recordkeeping difficulties (JA 42, 112). Foley was assisted in these negotiations by Leonard Feldman, a member of the Bar and counsel to Milberg & Weiss (JA 37, 254, 288). The Hayden Stone negotiations collapsed in late 1969. Foley's pique lead to a demand by him on Hayden Stone that it pay Feldman's fee. Hayden Stone paid Feldman $20,000 (JA 1142).

Negotiations With Blair. Foley learned that Blair might also be interested in obtaining additional capital (JA 35-39). In early 1970, Blair was a major brokerage firm. It had 38 branch offices coast to coast, approximately 50,000 customer accounts, and ranked by that measurement as approximately the fifteenth largest member organization of the Exchange.

Foley and Feldman met with Blair representatives a number of times. At the first of these meetings in February 1970, James J. Rush, a vice president and treasurer of Blair, told Feldman and Foley that Blair was experiencing back office problems which were the result of Blair's conversion of its eastern offices from the Automatic Computer System ("ACS"), a semi-automated system of bookkeeping and accounting for stockbrokers, to the Midwest Stock Exchange Service Corporation System ("Midwest System"), which was a fully computerized bookkeeping and accounting system (JA 52-53). The conversion from one back office system to another had been unusually difficult for Blair. The resulting confusion in the records made it difficult to obtain accurate figures for the preparation of Blair's net capital computation. Rush told Foley that Blair, as a result, could not be sure whether it was in compliance with the net capital rules of the Exchange (JA 54-55).*

* The net capital rule of the Exchange, Rule 325, is designed to assure liquidity to customers of the firms by requiring the firm to maintain a certain amount of assets in cash or cash equivalents. This liquidity is measured in terms of the ratio of "aggregate indebtedness" to "net capital" as those terms are defined in the rule. The required ratio was less than 2000% or 20 to 1. The net capital rule is not a measure of the equity or net worth available to protect investors in member firms. Net worth would include other assets (*e.g.*, real estate, furniture and fixtures, stock exchange seats) which are not given capital credit under the net capital rule. In addition, net capital for Rule 325 purposes does not include the full market value of securities in proprietary accounts. These securities are subject to a "haircut" or discount of 30% (or more if not readily salable) in computing net capital. Exchange Rule 325.10(14), 2 N.Y.S.E. Guide ¶ 2325.10(14) (1969). Difficulties with recordkeeping place a strain on the net capital of brokerage firms since they cannot claim capital credit for otherwise recognizable assets which as the result of paperwork problems cannot be fully identified on the firm's records. *Hirsch v. duPont, supra,* ¶ 96,011 at 91,539-40 n. 4.

After describing Blair's recordkeeping problems to Foley and Feldman, Rush also pointed out that Blair had been experiencing severe operating losses during the last half of 1969 (JA 54, E 359-60).

Foley viewed Blair as a brokerage firm in which current operational and financial difficulties permitted an investor to demand very favorable terms yet which could have a bright future after its current difficulties were overcome. Foley recognized a "turnaround" opportunity (JA 1160) and pursued further discussions with Blair. At a later meeting Foley met James B. Ramsey, president of Blair, and Oliver D. Vanderbilt, chairman of Blair's board of directors, and discussed Blair's history and background and plans for the future (JA 57-59). Additional meetings were held (JA 44). When an agreement in principle was reached, Feldman began working closely with John B. Richardson, Blair's inside counsel, on the agreements pursuant to which the Foley group would make its investment in Blair (JA 174-75).

Foley's deal with Blair contained extraordinary provisions giving Foley the right to withdraw his investment under certain circumstances. Foley was also able to demand a favorable arrangement for options to purchase a sizable block of the common stock of Blair and of Capital Management Corporation. If the options were exercised, Foley would have become the largest equity owner of Blair.

One of Foley's principal concerns was obtaining what he considered to be adequate protection against the loss of his investment through further declines in Blair's position (JA 48-50). In order to accomplish this, Foley insisted on certain "withdrawal rights" which would permit him to withdraw his investment under certain circumstances. Foley sought to have his subordinated investment rank ahead of the other subordinated investments in Blair by virtue of the withdrawal provision. The essence of the withdrawal provision was that it provided a "cushion" of $10 million of capital which would have to remain with

Blair as protection for Foley's investment (JA 49, 180, 184, 1069). If Blair's then approximately $20 million of capital was reduced by approximately $10 million, Foley's right to withdraw his securities would mature.

Form of Investment. Foley's investment in Blair was to take the form of a secured demand note (E 48) and collateral agreement (E 37-47). Separate option agreements gave Foley the right to purchase Blair common stock (E 61-71) and Capital Management Corporation stock (E 72-80). The terms of these agreements called for Foley to deposit securities with Blair which would serve as collateral for indebtedness from Foley to Blair evidenced by a secured demand note. The respective rights of Blair and Foley in the securities deposited as collateral were described in the collateral agreement.*

The withdrawal provision was found in paragraph V(b) of the collateral agreement (E 39-41). The provision permitted Foley to withdraw his investment if:

> (a) Blair's capital decreased by $10,000,000 as a result of net withdrawals of capital in subordinated

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* The arrangement with Blair would make Foley a "subordinated lender" to Blair. Subordinated capital in the securities industry is a unique arrangement which permits a person to make an investment in a member corporation which is roughly equivalent to a limited partnership in a member firm. The subordinated lender executes a secured demand note, payable on demand to the broker, collateralized by cash or securities deposited in a subordinated account. The broker, as holder of the note, has recourse only to the cash or securities deposited as collateral. The note and the securities are subordinated by the terms of the collateral agreement to the claims of customers and general creditors of the brokerage firm. The market value of the securities, discounted by a percentage (usually 30%) generally referred to as a "haircut," is included in the capital of the brokerage firm for the purposes of calculating net capital pursuant to Rule 325 of the Exchange.

In return for the subordination of his securities, the investor receives interest from the broker on the market value (or sometimes the net capital value) of his securities. The investor continues to receive all dividends, interest, stock splits, or other benefits of ownership of the securities and has the right to substitute securities of equal value.

accounts and/or net decreases in Blair's capital stock and surplus account (*e.g.*, through continued operating losses), or

(b) if the market declined in such a manner that the market value of securities deposited in subordinated accounts decreased by 25% *and* that decrease plus any capital decrease described above exceeded 50% of Blair's "original capital" as defined in the agreement.

"Original capital" was defined in the collateral agreement as the sum of $21,750,000. According to Richardson, who represented Blair in the drafting of the agreement, the "original capital" figure was intended to approximate Blair's actual capital as at February 28, 1970 (JA 1050). Feldman participated on Foley's behalf in discussions and negotiations as to how the precise figure was calculated (JA 1045-64).*

Blair's capital consisted of (1) subordinated capital (securities and cash invested in Blair and subordinated to claims of customers and general creditors) which as of February 28, 1970 was approximately $25,800,000 (JA 1049), and (2) any surplus or deficit in Blair's capital and surplus account (JA 1050). The amount in Blair's capital stock and surplus account as of February 28, 1970 was based upon a September 26, 1969 financial statement prepared by Arthur Young & Company as adjusted to reflect post-September 26 events, such as estimates of Blair's losses, the current value of certain assets of Blair, and recoveries resulting from research and reconciliation of out-of-balance securities positions which had been charged off at the insistence of Arthur Young as of September 26, 1969 (JA 1050-51, 1056-58, 1055). It was estimated that

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* In J. P. Foley & Co. v. Vanderbilt, 65 F.R.D. 523 (S.D.N.Y. 1974), the court considered the issue of privilege arising from the Foley-Feldman relationship. Following that decision and a similar ruling in this case (Record on Appeal, Doc. 25), plaintiffs waived any attorney-client privilege (JA 246, 264).

Blair's operating losses were approximately $1,500,000 from September 26, 1969 through December 31, 1969 (JA 1052). In the two months following December 31, 1969 Blair had sustained monthly losses estimated at $1,000,000. (JA 1052). These calculations resulted in an estimate of Blair's capital as of February 28, 1970 of $23,484,842.74 (E 413). This figure was further reduced by $2,104,920.25 which was the amount of a subordinated demand note contributed in February 1970 by Melville H. Ireland, a Blair director, whose right to withdraw the sum would mature shortly, and was not intended to affect Foley's withdrawal rights (JA 1059-60, 1064). After the Ireland February 1970 subordination was subtracted, Blair's capital position at February 28, 1970 amounted to $21,743,922.49 which was rounded off to $21,750,000 (E 413). The $21,750,000 amount was the figure included in the collateral agreement as "original capital." Feldman agreed to this computation as establishing the figure to be used as the basis for calculating Foley's withdrawal rights.

The Blair option agreement contained a warranty that "except as Blair has otherwise advised Optionee [Foley]," Blair did not know of any investigation nor any material violations of federal, state or other applicable law or any administrative regulation or any rules of the New York Stock Exchange or any other regulatory agency of which Blair was a member (E 70). Foley understood that Blair had disclosed that it was in violation of Rule 325 (JA 239) and that Blair's conversion to the Midwest System had created recordkeeping problems which might constitute a violation of Exchange recordkeeping rules (JA 52).

The Absence of Any Representations By the Exchange. On April 3, 1970, the closing of the transaction occurred in Blair's offices (JA 44, 75-76). Throughout the period in which Foley negotiated with Blair it is conceded that neither Feldman, Foley, nor any other plaintiff had any communication with the Exchange (JA 265, 302, 303). The Exchange made no representations to Foley or his representatives and it was aware of no omissions on the

part of Blair or its representatives in making full disclosures to Foley and Feldman of the situation facing Blair.

Foley's April 3 Representation to the Exchange. After April 3 the Exchange received Foley's application for approval as a subordinated lender to Blair (E 84-90) and an April 3 letter to the Exchange (E 83). This letter had been reviewed by Feldman, executed by Foley at the closing, and was addressed to the Exchange (JA 80, 82, 1087-88, 1163-64, E 83). It stated:

> "Accepting the suggestion of the New York Stock Exchange, I have conducted such investigation of Blair & Co., Inc. and of its participants as I consider desirable, appropriate and necessary under the circumstances. Further, I have been furnished with all financial information with respect to Blair & Co., Inc. as I have requested, including the latest certified audit by Arthur Young and Company dated December 5, 1969 and a recent computation of net capital prepared by Blair & Co., Inc. as of February 28, 1970, which indicates that as of that date Blair & Co., Inc. was in violation of Rule 325 of the Board of Governors of the New York Stock Exchange.
>
> "My subordinated loan to Blair & Co., Inc. of even date herewith is not being made in reliance upon the standing of Blair & Co., Inc. as a member organization of the New York Stock Exchange or on the Exchange's surveillance of the organization or its capital position. I am familiar with the fact that Blair & Co., Inc. has books and record problems as a result of conversion to the Midwest Stock Exchange Service Bureau and that the New York Stock Exchange has placed restrictions upon Blair & Co., Inc. as set forth in its letter of March 10, 1970.
>
> "I agree that the New York Stock Exchange has no responsibility to disclose to me information concerning Blair & Co., Inc. which it may now have or at any

time in the future may have or to protect my interest in the member organization. I agree, for myself, my personal representatives, successors and assigns, that neither the New York Stock Exchange, its Special Trust Fund nor any governor, officer, trustee or employee of said Exchange or Fund shall be liable to me with respect to Blair & Co., Inc."

The Exchange's letter to Blair of March 10 (E 91-92), which Foley represented he was familiar with, says:

"The purpose of this letter is to express the Exchange's serious concern over the conditions currently existing at Blair & Co. and apparently traceable to the recent conversion to the Midwest Service Bureau.

"As a result of discussions had with representatives of your firm and from observations made by an Exchange examiner in reviewing your books and records it appears that substantial difference and suspense accounts exist. Figures on customers' debits and credits, bank loans, aggregate indebtedness and probably many other items are not reliable. As a consequence it is impossible to compute any meaningful capital position for Blair & Co., Inc. Additionally, attention is called to the fact that your firm has not responded to a Special Financial Questionnaire which was due on February 13, 1970. Similarly a response to the Special Operations Questionnaire as of January 31, 1970 is long overdue.

"We are fearful that the records of Blair & Co., Inc. are in such condition that you are in danger of losing control of customers' accounts and the ability to properly supervise registered representatives. Accordingly we feel that steps must be taken promptly to contain the volume of your firm's business until such time as the condition of the books and records is significantly improved. To this end the Exchange will not consider the approval of any new registered repre-

> sentative or additional branch offices except in those instances where your firm is already committed. In this connection please submit to us a list of all proposed registered representatives to whom you have made employment commitments. Additionally, you are directed to refrain from any further advertising or promotional activities which might tend to increase your volume of business."

The Exchange could only conclude that full disclosure had been made based upon the representations made to it by Foley in his April 3 letter.

B. The Condition of Blair

Conversion to the Midwest System. In 1969 Blair had two divisions, its Schwabacher Division or Western Division (consisting of the offices which it had acquired on February 28, 1969 from Schwabacher & Co., a former member firm based in San Francisco), and its Blair Division or Eastern Division (consisting of the offices which it owned before the Schwabacher acquisition). The Schwabacher firm had converted to the Midwest System before it was acquired by Blair. The back offices of the Blair Division were then on the ACS. After the acquisition, Blair maintained two separate back offices pending its decision as to the methods to be used and the system to be selected for consolidation of these back offices.

In 1969 Arthur Young & Company was retained by Blair to perform an annual surprise audit of its affairs under Exchange Rule 418. Moreover, Arthur Young had been requested to perform a comprehensive review and evaluation of operating procedures and controls and to lay out a plan for consolidation of operations of the two divisions—a task requiring more personnel and time than a normal audit. By letter dated May 7, 1969 (E 445-46), Arthur Young requested the Exchange's permission to conduct a "split

audit,'' performing an examination of the Schwabacher Division of Blair as of June 1969 and an examination of the Blair Division as of September 1969. The request was based upon the manpower required to conduct audits of both divisions and Arthur Young's understanding that there were no significant intercompany dealings and accounts, that the firms were using distinct clearing designations and that this situation would facilitate a ''separate entity'' examination.

Since the reports on such an audit were required to be filed with both the Exchange and the Securities and Exchange Commission (''Commission''), Arthur Young's request was reviewed with Andrew Barr, Chief Accountant of the Commission. Mr. Barr, after having conferred with Irving Pollack and Stanley Sporkin of the Commission staff, advised the Exchange that the Commission would permit separate audits of the two divisions of Blair in 1969 (E 111). By letter dated May 23, 1969 (E 447-48), the Exchange advised Arthur Young that its request had been approved but that in addition to the audited answers to the financial questionnaire from the division subject to the audit, unaudited answers to a special financial questionnaire as of the same date would be required from the division which was not being audited.

In November 1969, while the audit of the Blair division was still in progress, Blair converted the recordkeeping operations of its Blair Division from ACS to the Midwest System (JA 526, E 227). Although the Exchange had earlier been assured by representatives of Blair that its conversion would be made on a branch office by branch office basis in order to avoid loss of control (E 389, 113, JA 537), Blair decided to convert all of its offices en masse to the Midwest System at the same time (JA 537-38). Blair's decision to proceed in a wholesale fashion was based upon assurances from the Midwest System that it would make adequate personnel available to assist Blair in avoiding any problems arising from this conversion (JA 528).

On December 8, 1969, Blair's audited answers to the financial questionnaire were submitted to the Exchange along with Arthur Young's report dated December 5, 1969 (E 115-45). In addition, Arthur Young submitted a Supplementary Report also dated December 5, 1969 (E 226-27) which, contrary to earlier statements made to the Exchange (Exhibits DDDD, EEEE), stated that it had found inadequacies in the accounting control and procedures for safeguarding securities as of September 26.

Blair's Difficulties With the Midwest System. In December 1969, after completion of the audit, James B. Ramsey, president of Blair, asked George Morpurgo, a former employee of the Midwest Stock Exchange Service Bureau who had extensive experience in assisting brokerage firms in their conversion to the Midwest System, to study the progress of Blair's conversion (JA 578, 134). In early January 1970, Morpurgo reported that the conversion was encountering difficulties and Ramsey took steps to report these difficulties to the regulatory agencies (both the Commission and the Exchange) and to Blair's investors.

On approximately January 15, 1970, Blair scheduled a meeting of capital contributors to Blair at the Bankers' Club in New York at which Ramsey outlined the difficulties encountered in the conversion of Blair's back office and disclosed that the state of records made it difficult for Blair to compute any meaningful net capital position or to assure itself that it was in compliance with Exchange Rule 325. Ramsey asked the investors in Blair to assist him in acquiring additional capital for the firm in order to assure compliance with capital requirements until the records were straightened out (JA 446-47, 582-83).

At about the same time Ramsey and Vanderbilt went to the New York Regional Office of the Commission and disclosed at a meeting chaired by Kevin Duffy, Regional Commissioner, that the conversion to the Midwest System was causing substantial problems for Blair, and prevented it from calculating a meaningful net capital position. This

meeting was also attended by a representative of the Exchange. During this meeting the Commission advised Ramsey that it did not feel it necessary or appropriate at this time for Blair to cease operations. Instead, the Commission urged Ramsey to keep Blair going and to keep the Commission informed of Blair's progress in strengthening its capital position and straightening out its records (JA 552-56, 473-75, 398-401).

On January 16, 1970, the Exchange sent one examiner to Blair to investigate its current capital position and the progress of the conversion to the Midwest System (E 325, JA 757-58). This examiner remained at Blair until May, investigating its capital and operational condition.

On February 10, 1970, Blair submitted its special operations questionnaire as of December 31, 1969 (E 102-10) reporting a violation of the Exchange's net capital requirements, and indicating that "both aggregate indebtedness and capital charges have been seriously inflated as a result of the conversion to the Midwest System" (E 102). On February 10, 1970, John J. Deignan, a Supervising Coordinator in the Exchange's Department of Member Firms, spoke to Rush, who assured him that Blair was taking steps to improve its net capital position and had several alternatives available to it, including the sale of Blair assets which had no value for capital purposes (for cash which had 100% value), the retention of subordinated capital otherwise scheduled for withdrawal, and the possibility of new capital in the form of secured demand notes (E 326-27).

The Exchange Insists on Capital Compliance. By February 19, 1970, the Exchange sent a letter to Ramsey (E 171) insisting that Blair take steps to meet the Exchange's minimum capital requirements by the close of business on February 25, 1970. The letter stated that if net capital requirements were not met, restrictions designed to curb Blair's volume would be imposed. In a letter dated February 26, 1970 (E 169-70), Blair reported to the Ex-

change that it had improved its net capital by obtaining a secured demand note having a net capital value under Rule 325 of at least $1,400,000 from Melville H. Ireland, one of its directors. It was also reported that Foley had agreed to contribute a secured demand note with a net capital value of approximately $2,500,000; that Vanderbilt planned to pledge restricted securities with Chemical Bank in order to obtain a loan, the proceeds of which would be loaned to Blair on a subordinated basis; and that the approaching final settlement of the debt of former partners of Schwabacher & Co. to Blair would result in the reduction of Rule 325 "haircuts" on securities in secured demand note collateral accounts, and thus improve Blair's capital. On March 6, 1970, the Exchange had another meeting with representatives of Blair and was assured that Blair's operations were presently current on a daily basis and that Blair was working three shifts a day and had hired a 40-man task force to correct old recordkeeping errors (E 329-30).

In a letter to Ramsey dated March 10, 1970, from Robert M. Bishop, Vice President of the Exchange and Director of its Department of Member Firms (E 91-92) (quoted *supra*, at pp. 12-13), the Exchange expressed a "serious concern over the conditions currently existing at Blair & Co. and apparently traceable to the recent conversion to the Midwest Service Bureau." In this letter the Exchange imposed restrictions on Blair in order to contain the volume of its business until the condition of Blair's books and records was significantly improved. These restrictions included refusal to approve any new registered representatives or additional branch offices and discontinuance of any further advertising or promotional activity.

Based upon preliminary figures made available on March 13, 1970 by Blair to the Exchange examiner at Blair indicating a net capital deficiency of about $2,500,000 as of January 31, 1970 (E 331), the Exchange, in a letter dated March 16, 1970 (E 332), directed Blair to improve its capital position by at least $3,500,000.

In a letter dated April 1, 1970 (E 172-73), the Exchange, based upon revised capital computations for Blair showing a deficiency of $3,000,000 as of February 28, 1970, insisted that Blair comply with Rule 325 by the close of business on Friday, April 3, 1970. This letter stated that the "most logical" way to obtain this desired capital was to raise cash by selling the securities used as collateral for secured demand notes of members and allied members ("insiders"). Such sales would increase Blair's net capital position by the 30% "haircut" imposed on securities which were included in the firm's net capital. The letter also acknowledged that Blair was seeking to complete the borrowing from Foley and to increase net capital by selling the securities pledged as collateral for secured demand notes of former partners of Schwabacher. These steps promised to yield net capital value of $2,000,000 and $1.200,000, respectively, and would bring Blair into capital compliance.

The SEC Gives Blair Until April 9 to Reach Capital Compliance. On April 3, 1970, Deignan was informed by a telephone call from Joseph Daley, a partner in Mudge, Rose, Guthrie & Alexander, counsel to Blair, that the Commission had required Blair to complete a questionnaire concerning its capital position (E 336). Although the questionnaire was due on April 3, an extension had been granted by the Commission until Monday, April 6. Daley also reported that the closing of the Foley transaction was in progress and that a determination would be made on Monday as to the priority of selling securities in secured demand note collateral accounts of members or allied members.

On Monday, April 6, Daley and Rush of Blair met with representatives of the New York Regional Office of the Commission. Daley reported to Deignan that the Commission had given Blair until Thursday, April 9, to clear up the capital deficiency (E 340-41). Daley acknowledged that Blair had not met the Exchange's directive concerning net capital compliance by the close of business on April 3, but

estimated that approximately $5,000,000 in net capital value would be obtained by selling for cash secured demand note collateral securities of insiders which would avoid the "haircut" imposed on these securities.

On April 9, 1970, Rush of Blair reported to Deignan that Blair had improved its capital ratio to 1630% based upon the Foley loan, the capital released by the sale of insider secured demand note securities for cash, and the sale of an Exchange seat (E 402). The Commission received a similar report (E 414-17). On April 10, an additional $500,000 in net capital was realized by further sale of securities in secured demand note accounts, lowering Blair's capital ratio to 1519% (E 403). Thus, Blair's capital ratio was well in compliance with the 2000% requirement of Rule 325.

Blair Adopts a Clean-Up Program. On April 15, 1970, Deignan attended a meeting in the New York Regional Office of the Commission at which William Moran, Assistant Regional Administrator, stated that the Commission was interested in keeping Blair in business if at all possible (E 374-77). It was reported at this meeting that Daley was working with Blair to prepare a written program for the clean-up of recordkeeping problems arising from the conversion to the Midwest System. The program was submitted to the Commission in a letter dated April 21, 1970 (E 378-83). On April 28, Blair reported to the Exchange that it had continued to sustain losses but that additional capital was being obtained through the resolution of stock record differences and from sales of collateral securities underlying secured demand note accounts (E 386-87).

During May the stock market declined further and losses at Blair continued. Blair engaged in merger discussions with other member firms and made plans to close offices, reduce expenses, and improve its operations in order to accomplish the objective of profitable operation

in June 1970. Nevertheless, in June 1970, it was necessary for Blair to begin steps to divest itself of its branch offices to remain in net capital compliance.

C. Foley's Reaction to the Collapse of Blair

Assertion of Withdrawal Rights. By the end of July Blair needed additional cash to accomplish the transfer of accounts to other firms. Accordingly, it became necessary to demand payment of secured notes contributed to Blair by outsiders such as Foley. A letter dated August 5, 1970 was sent to Foley which outlined the circumstances leading to this need for cash (E 365-67, JA 243). Similar letters were sent to other subordinated lenders of Blair.

Foley contended that his right to withdraw had matured (JA 249) and sought a preliminary injunction from the New York State Supreme Court restraining Blair from selling any of the securities which he had subordinated to secure his demand note. Foley's motion for a preliminary injunction was denied (E 369-72) and Foley's claims were submitted to an arbitration panel, where they were dismissed as without merit (E 46, 373, Exhibit O, JA 249-51).

Litigation. On September 28, 1970, Foley filed an action in the Southern District of New York against Arthur Young & Company, Blair, and certain of Blair's officers and directors. *J. P. Foley & Co. v. Vanderbilt*, 70 Civ. 4914 CHT (S.D.N.Y.). In *J. P. Foley & Co. v. Vanderbilt*, 523 F.2d 1357 (2d Cir. 1975), this Court considered the issue of disqualification of Foley's trial counsel on the ground that Feldman, of counsel to that firm, ought to be called as a witness at trial. This action has not yet been tried.

Approximately ten months after filing the *Vanderbilt* action, Foley commenced this action against Amex and the Exchange.

On September 29, 1970, Foley filed an involuntary petition in bankruptcy against Blair. *In re Blair & Co.*, 70 B. 755 (S.D.N.Y.). Blair then filed a petition for relief under Chapter XI of the Bankruptcy Act and obtained a

stay of the administration of the involuntary bankruptcy proceedings. On December 11, 1972, this Court reversed a decision adjudicating Blair to be a bankrupt. *Blair & Co.* v. *Foley*, 471 F.2d 178 (2d Cir. 1972). The Supreme Court granted *certiorari*, 411 U.S. 930 (1973), heard oral argument and remanded the case on the ground that it no longer presented a "live controversy" since the District Court on October 1, 1973 had confirmed an arrangement by Blair under Chapter XI. *Foley* v. *Blair & Co.*, 414 U.S. 212 (1973). On remand, this Court dismissed the appeal as "moot." 495 F.2d 299 (2d Cir. 1974).

Argument

The principles governing directed verdicts are clear. In *Brady* v. *Southern Railway Co.*, 320 U.S. 476, 479-80 (1943), the Supreme Court stated that the purpose of a directed verdict is to save the result "from the mischance of speculation over legally unfounded claims." This Court in *Bigelow* v. *Agway, Inc.*, 506 F.2d 551, 554 (2d Cir. 1974), stated:

> "The non-moving party is given the benefit of all reasonable inferences from the evidence, and evidence unfavorable to it may be considered only if that evidence stands uncontradicted and unimpeached."

Accord, Fleming v. *McEnany*, 491 F.2d 1353, 1357 (2d Cir. 1974); *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 885 (2d Cir. 1972).

Much of the significant evidence presented during plaintiffs' case was documentary. The bulk of this documentary evidence was unfavorable to the plaintiffs' claims and was uncontradicted and unimpeached. The Exchange's motion for a directed verdict relied upon this unimpeached documentary evidence and upon the oral testimony of Foley himself or other witnesses as to which there was no contradiction at all.

The unimpeached evidence shows that the Exchange made no representations to plaintiffs and had no knowledge

of any misrepresentations which plaintiffs alleged were made by others. It also shows that Foley was aware of Blair's difficulties and chose to proceed with his investment. On these facts, the Exchange has no duty to disclose to Foley and cannot be held liable either directly or vicariously.

I

The Exchange Had No Duty to Convey Information to Foley

Foley was a sophisticated investor, aided by a sophisticated counsel. Foley was looking for rapid profit through investment in what he believed to be a turnaround situation. He knew the worst about Blair's condition, but believed it would improve. If his belief failed to materialize, he and his counsel believed that their formula for withdrawal would prevent any loss to Foley.

From the very first meeting that Foley had with Blair in February 1970, Blair furnished Foley with full and complete disclosure of its operational and financial condition. The representatives of Blair gave Foley access to any information which he requested and took care to impress upon him the risks which were involved in the investment and the uncertainty of Blair's figures as a result of its difficulty with its books and records. Foley was told that Blair had been suffering severe operating losses (JA 54); that the conversion of the Blair Division back office to the Midwest System in November 1969 had led to extensive recordkeeping difficulties (JA 52-53); and that these difficulties were such that Blair was unable to assure itself that it was in compliance with the Exchange's net capital rule (JA 55). Having received this information, Foley was not dissuaded; instead he was encouraged since he knew it increased his bargaining position.

The disclosure to Foley was made not only by direct communication to him but also by direct communication to his attorney, Feldman. Feldman and Richardson, Blair's inside counsel, had extensive discussions concerning the formulation of the withdrawal provision. In the course of

these discussions, it was disclosed to Feldman that Blair's losses to the end of 1969 were $1.5 million and had continued through February 28, 1970, in the amount of $1 million per month (JA 1052-53); that Blair had, at the insistence of its auditor, charged off approximately $900,000 in 1969 for stock record differences but had recovered approximately $500,000 as a result of research and reconciliation of such differences (JA 1054-56); that Melville H. Ireland, a director of Blair, had contributed a secured demand note of approximately $2 million market value in February 1970 and had the right to withdraw that amount after 60 days (JA 1059-60, 1064). Plaintiffs contend (Br. 6, 12, 21, 29) that Ireland's February 1970 $2,000,000 contribution and his September 1969 $2,000,000 contribution were improper and "clandestine." The undisputed evidence establishes that neither of these contributions, nor a June 1969 Ireland contribution of approximately $1,000,000, was withdrawn by Ireland (JA 892, 996, 1025-35). In fact, the entire Ireland contribution of $5,000,000 remained in Blair and was used for satisfaction of the claims of Blair's customers. Moreover, Feldman negotiated the withdrawal provision in Foley's collateral agreement on the premise and with knowledge that the February 1970 $2,000,000 contribution by Ireland might be withdrawn (JA 1064, 1062-63, E 413).

On April 3, 1970, the closing occurred* and Foley signed the knowledgeability letter (E 83) acknowledging and

* Rush testified that he told Foley before the closing that operating losses had continued from February 28, until the end of March. He also showed him a series of letters including (1) the March 10, 1970 letter to Blair from the Exchange (E 91-92) which imposed restrictions upon Blair and expressed the Exchange's serious concern about Blair's recordkeeping; (2) the April 1, 1970 letter from the Exchange to Blair (E 172-73) which insisted that Blair bring itself into net capital compliance by April 3, 1970 and recognized that the $3 million needed for compliance could be raised by liquidation of securities held by Blair as collateral for secured demand notes of members and allied members or by a combination of the Foley loan and liquidation of securities in the subordinated accounts of former Schwabacher partners; and (3) the proposed knowledgeability letter from Foley to the Exchange (E 83, JA 1161-71).

representing to the Exchange that he had investigated Blair, had been furnished with all financial information which he had requested, including Arthur Young's audit of Blair, and Blair's capital computation as of February 28, 1970, that he knew Blair was in violation of Rule 325 and had books and records problems as a result of its conversion to the Midwest System and that the Exchange had imposed restrictions on Blair as set forth in the Exchange's letter of March 10, 1970 (E 91-92).

At no time during these negotiations did plaintiffs have any communication with the Exchange. Since there is no evidence that the Exchange made any statement to Foley or any of his agents, the Exchange could not have made a "misrepresentation" or omitted to state a material fact necessary to make its statements not misleading.

Moreover, as this Court has recently held in *Hirsch* v. *duPont, supra,* and *Murphy* v. *McDonnell & Co., supra,* the Exchange has no duty to disclose to capital contributors information about its member organizations.

In *Hirsch,* plaintiffs claimed that the Exchange had failed to reveal to them duPont's 1969 capital deficiency and its cure by the liquidation of long differences not traced to specific errors. This Court held:

> "We believe that the law is clear that the New York Stock Exchange does not have a general obligation requiring it to disclose to member firms in merger negotiations all that it knows about each participant. Although the Exchange has important duties toward the public in our system of supervised self-regulation, *see Arneil* v. *Ramsey,* [Fed.Sec.L.Rep. (CCH) ¶ 96,865 (2d Cir. Feb. 16, 1977)], it has never been conceived as an organization founded to guarantee fair dealing in its *members'* relations with one another. As we have indicated, its raison d'etre is to see that the members' responsibility to the public is observed." (¶ 96,011 at 91,544-45)

Plaintiffs in *Hirsch* argued that the duty to enforce the Exchange's net capital rule gave rise to a duty of disclosure. The Court rejected that argument also:

> "[A]s we have attempted to indicate, the Stock Exchange's duty to enforce its own rules is owed to *public investors*. . . . The interests of public investors and customers of a brokerage may often clash with those of private investors. Such conflict could scarcely be more evident than it is here, where the Stock Exchange's attempt to encourage a solution to duPont's capital problems may very well have been in the interest of duPont's customers, even though immediate suspension would have saved the appellants from a serious mistake. Our holding in *Arneil* was intended to assure that the Stock Exchange's undivided loyalty is to the public investor. We will not undermine the achievement of this end by permitting a limited partner to recover under rule 10b-5 *solely* on the basis of an asserted violation of the Exchange's duty of self-regulation, where his recovery under § 6 would be precluded by our decision in *Arneil*." (¶ 96,011 at 91,545)

The plaintiffs were subordinated lenders in *Murphy* v. *McDonnell & Co., supra.* They also alleged failure by the Exchange to disclose information about a member organization (McDonnell) to them as capital contributors. This Court, acknowledging that the Exchange had made no misrepresentations to plaintiffs, stated that "[l]iability under 10b-5 therefore could be based only upon breach of some duty to disclose." Plaintiffs argued that a duty to disclose arose from "active participation" in the transactions because the Exchange is required to approve the qualification of persons who invest in member organizations and because the Exchange was pressing McDonnell to satisfy the net capital requirements. These activities of the Exchange were rejected as giving rise to a duty to disclose.

> "We do not believe that the activities of the Exchange in this case constitute 'participation' under

Section 10(b) and Rule 10b-5. *Cf. Hirsch* v. *duPont, supra.* We agree with the district court that the potential liability of the Exchange under Section 6 to *public* investors should constitute the limit of the Exchange's duties under that provision. *See Weinberger* v. *New York Stock Exchange,* [403 F.Supp. 1020, 1026 (S.D.N.Y. 1975)]. And we see no justification beyond that for imposing on the Exchange a 10b-5 liability based upon an alleged duty to speak which we have found not to exist under Section 6. If we imposed such a duty, the practical effect would be to require the Exchange to suspend a firm immediately upon finding it in default of the net capital rule. For the risk that liability might be imposed on the Exchange itself if the member firm made fraudulent representations in soliciting additional capital, *without the knowledge of the Exchange,* would be too great to allow the Exchange to suffer a delay that might enure to the benefit of the customers of the firm and to the stability of the financial community. A duty to disclose would in such case amount to an imperative to close the firm." (¶ 96,021 at 91,588)

The recent decisions in *Hirsch* and *Murphy* are based on firmly established principles, *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1289, 1302 (2d Cir. 1973) (en banc); *Wessel* v. *Buhler,* 437 F.2d 279, 283 (9th Cir. 1971); *Weinberger* v. *New York Stock Exchange,* 403 F.Supp. 1020, 1026 (S.D.N.Y. 1975),* and require the affirmance of the judgment herein.

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* Plaintiffs misconstrue Fischer v. New York Stock Exchange, 408 F.Supp. 745 (S.D.N.Y. 1976). It does not support their proposition that "the court found a duty to disclose even absent participation" (Br. 24). *Fischer* arose on the Exchange's motion for summary judgment before any discovery had taken place. There were allegations that the Exchange "directly participated in the situation" based on conversations between an Exchange officer and plaintiffs. 408 F.Supp. at 751. Recognizing that plaintiffs "have a long road to travel before establishing that the Exchange owed them a duty of disclosure," the court in *Fischer* denied the Exchange's motion for summary judgment until plaintiffs had "an opportunity to develop more fully the facts." 408 F.Supp. at 754.

II

The Exchange Cannot be Held Liable as an Aider and Abettor

Foley claimed that the Exchange aided and abetted the commission of fraud by Blair and its officers and directors. In *Hirsch* v. *duPont, supra,* ¶ 96,011 at 91,544, this Court found that "knowing assistance of or participation in a fraudulent scheme" was necessary to establish such liability. "[K]nowledge of the fraud, and not merely the undisclosed material facts, is indispensable."

The undisputed evidence showed that the Exchange's knowledge of the transactions between Foley and Blair did not include knowledge of the content of negotiations between Blair and Foley. The Exchange's regulatory role does not require it to monitor every discussion between member firms and prospective capital contributors. The Exchange knew nothing of any alleged fraudulent statements or omissions made by the representatives of Blair to Foley or Feldman. In addition, the Exchange never encouraged any representative of Blair to make any fraudulent statements or omissions. The Exchange, therefore, cannot be held liable for aiding and abetting the alleged wrongdoing of others.

The fact that Blair had been negotiating with Foley concerning a capital contribution was reported to the Exchange in a letter dated February 26, 1970 (E 169-70). In responding to this letter, the Exchange requested that a knowledgeability letter be supplied to the Exchange in which Foley acknowledged that he knew about the condition of Blair and violations by Blair of Exchange rules and regulations (Exhibit 88). Neither Foley nor Blair objected to this letter (JA 1088). When Foley signed the April 3, 1970 knowledgeability letter, it was a representation to the Exchange that full disclosure had been made as to the matters mentioned in the letter. Nothing had occurred during the period of negotiation of the Foley transaction which would lead the Exchange to suspect that any misrepresen-

tation or omission had occurred. The Exchange's receipt of Foley's April 3 letter was further confirmation that full disclosure had been made.

The Exchange also received from Blair preliminary drafts of the collateral agreement, the Blair option agreement and the CMC option agreement between Blair and Foley in a letter dated March 23, 1970 (E 333). Nothing in these drafts raised any question as to the fact that full and complete disclosure was being made to Foley. In fact, the Blair option agreement in paragraph 10 disclosed that regulatory violations had been discussed with Foley—that paragraph limited any warranty by Blair of compliance with the qualification "except as Blair has otherwise advised Optionee [Foley]" (E 70). Such a qualified warranty was not, as Foley claims, a representation that Blair was not in violation of any Exchange regulation or that as a result of plaintiffs' subordination Blair would be in compliance with all Exchange regulations. Nothing in the drafts of the agreements gave the Exchange any knowledge of, or cause to suspect, misrepresentations or omissions. Certainly, the Exchange cannot be held to presume fraud by its members when they deal with capital contributors. Blair was a respected member firm which dealt with disclosure issues all the time in the course of its underwritings. It was counseled throughout the Foley transaction by Segal of Mudge, Rose, Guthrie & Alexander, learned outside counsel (JA 76-77; 1074). Obviously, the Exchange had no duty to monitor every discussion concerning capital contributions to Blair or to know the content of every statement made by all representatives of Blair to Foley and Feldman. Indeed, such a proposition would be absurd. Yet, that is what plaintiffs' fraud claims against the Exchange come down to.

In *Murphy* v. *McDonnell, supra,* the trial court had directed a verdict in favor of the Exchange on claims based on Rule 10b-5, finding that the Exchange had neither knowl-

edge nor reason to suspect that any fraudulent representations were being made. This Court affirmed, stating:

> "Here it is clear that the Exchange did not know of or have any reason to suspect any fraud on the part of the brokerage firm or its officers. As we recently wrote in *Hirsch* v. *duPont*, [*supra*,]: 'Knowledge of the fraud, and not merely knowledge of the undisclosed material facts, is indispensable' to create a duty to disclose in these circumstances." (¶ 96,021 at 91,588)

Plaintiffs claim that Blair's statement of financial condition as of September 26, 1969 was a false representation since it omitted any reference to stock record differences or the inadequacy of Blair's accounting control which Arthur Young had discovered during its September audit of the Blair Division (Br. 8-9). Plaintiffs called no expert witness to support their claim of a deficient financial statement. The uncontradicted evidence established that the statement of financial condition was in accordance with generally accepted accounting principles and was not false or misleading in any respect.

On December 8, 1969, the Exchange received Answers to Financial Questionnaire of the Blair Division of Blair & Co., Inc. at September 26, 1969 (E 115-45). These answers had been audited by Arthur Young and included Arthur Young's report dated December 5, 1969 (E 115). Blair also filed Answers to Special Financial Questionnaire as of September 26, 1969 for the Schwabacher Division (Exhibit FFFF). These answers had not been audited as of that date because Arthur Young had requested permission in May 1969 to conduct a "split audit" of Blair (E 445-46), and the Exchange, after obtaining the consent and approval of the Commission (E 111), agreed to this procedure (E 447-48). The Schwabacher Division had been audited by Arthur Young as of June 27, 1969 (E 228-54), and a second audit of that Division as of Sep-

tember 26, 1969 was not required. The Exchange, on December 8, 1969, also received a document entitled Combining Answers to Financial Questionnaire of Blair & Co., Inc. at September 26, 1969, which was also accompanied by a report of Arthur Young dated December 5, 1969 (E 146-68). This Arthur Young [illegible] stated that Arthur Young had not audited the Schwabacher Division figures which had been used in this document and did not express an opinion on the combining answers except to say that they had been properly combined (E 147). All of these documents were required to be filed with the Commission and were so filed.

In addition to submitting audited Answers to Financial Questionnaire as required by Exchange Rule 417, a member firm of the Exchange must also make available to its customers a statement of financial condition in compliance with Exchange Rule 419. This document was also filed with the Exchange (E 174-75) and the Commission (E 459-64).*

Foley claims (Br. 8-9) that the statement of financial condition should have set forth a liability item for stock record differences which were discovered during the audit of the Blair Division and that the statement of financial condition should have contained specific references to the Supplementary Report on the inadequacy of Blair's accounting control filed by Arthur Young. No testimony established that the information contained in the Answers to Financial Questionnaire concerning these subjects was required to be shown on the statement of financial condition. Plaintiffs, in any event, were aware of the underlying facts. Furthermore, the Exchange is entitled to rely on the auditing judgment of Arthur Young and is not

* Plaintiffs contend that the submission of the statement of financial condition to the Exchange means that it was "prepared" by the Exchange (Br. 8). As Mr. Bishop testified, the Exchange examiners verified that the numbers correspond to those in the Answers to Financial Questionnaire (Tr. 2149). The statement of financial condition was in no way "prepared" by the Exchange.

obliged to look behind Arthur Young's report on the financial statement.

Under the applicable auditing requirements of S.E.C. Form X-17A-5 and Rule 417 of the Exchange, an auditor must examine the stock record* of each security handled by a broker-dealer. The auditor must count each security on hand and confirm positions of securities in other locations (*e.g.*, on loan to a bank, in the fail to receive account, etc.). At the conclusion of an audit, the differences on the long and short side are valued pursuant to Form X-17A-5 and Rule 417, and the total valuations are reported in answer to question 13 of the Answers to Financial Questionnaire.

The final valuations which Arthur Young reported at September 26, 1969, for the Blair Division of Blair & Co., Inc. were $2,420,732 "long" (that is, stock count and confirmation showed that $2,420,732 in value of securities was shown on the stock record but these securities were not shown to be owed to any account); and $2,404,974 "short" (that is, stock count and confirmation showed that $2,404,974 in value of securities was shown to be owed to an account but the actual physical location of the securities had not been determined by the conclusion of the audit) (E 162, 166).

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* The "stock record" is a record which broker-dealers must maintain to reflect positions in all securities handled by the firm. See Rule 17a-3(a)(5), 17 CFR § 240.17a-3(a)(5); Petrillo and Bullock, *Processing Securities Transactions* 106 (1969). Every security transaction by a broker-dealer results in offsetting dual entries on the "stock record." A purchase of stock for a customer's account, for example, results in a long position for the customer and (when the security is received) a short position for securities held in the box (*i.e.*, securities located in physical possession of the firm). Subsequent delivery of the security to the customer results in cancellation of the long entry and reduction of securities short in the box. As stated in the AICPA publication, *Audits of Brokers and Dealers in Securities* 13-14 (195[illegible]) "Because long and short refer to two aspects of the same thing, that is, the ownership of securities and their location, the long and short sides of the securities sheet must balance (just as debits and credits in ordinary bookkeeping must balance)."

Throughout this litigation, plaintiffs have ignored the long differences and have called the short differences "missing securities." This is a false and misleading description since security differences may arise from nothing more substantial than a bookkeeping error. *See, e.g., Hirsch* v. *duPont, supra,* ¶ 96,011 at 91,540 n.5; AICPA, *Audits of Brokers and Dealers in Securities* 24 (1973). The value of the "unresolved" differences of a broker is neither an asset nor a liability of the firm. Security differences, both long and short, represent positions which are not in balance at the point of time at which the broker is audited, and which cannot be wholly reconciled at the time of the completion of the audit.

Viewing the unresolved security positions as a whole, it is necessary for the auditor of a broker-dealer to examine the nature of the differences and the action being taken to resolve them. Based upon this review, the auditor must exercise its judgment and determine the proper method of reporting. At the time of the audit, Arthur Young had made a direct charge or write-off of $900,000 to the surplus account. Thus, the statement of financial condition (E 2-3) took the securities differences into account in the item "Capital stock and surplus less deficit" (JA 1056). Recoveries and resolutions of these out-of-balance positions were made after the audit in the amount of $500,000 (JA 1054-55), and this situation was discussed with Feldman in arriving at the definition of "original capital" for purposes of constructing Foley's withdrawal formula (JA 1056). Especially inappropriate would have been the treatment plaintiffs are apparently advocating—a "reserve" charging off the entire amount of the unresolved short differences to profit and loss and wholly ignoring the value of the long differences. And, for any person sufficiently interested in the exact amount of Blair's stock record differences as of September 26, 1969, both sides of the difference account were set out in full in its Answers to Financial Questionnaire (E 162, 166, 153-54).

Plaintiffs also claim that the Blair statement of financial condition was fraudulent because it did not quote the Supplementary Report in which Arthur Young stated that there was an inadequacy in the Blair Division's accounting system and internal accounting control at September 26, 1969, and that certain steps were being taken to rectify it. This letter of comments was submitted to the Commission and to the Exchange as required by Form X-17A-5 of the Commission and Exchange Rule 417 (Tr. 1980). In 1969 both the Commission's and the Exchange's rule specifically permitted the letter of comments to be filed separately and in a non-public file. Sec. Exch. Act Release 8172, [1966-1967 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,475 (Oct. 3, 1967); Exchange Rule 417, 2 N.Y.S.E. Guide (CCH) ¶ 2417 (1969).

Since the filing of the letter in a non-public file was specifically provided by the Commission's rule, no liability may be imposed on a person for following it. Section 23(a) of the Exchange Act, 15 U.S.C. § 78w, provides that "No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission." *See Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1294 (2d Cir. 1973). Additionally, of course, any allegation that the existence of the letter was actively concealed must fail. The Arthur Young report on Part I of the Blair Division Answers to Financial Questionnaire (E 155), filed in the public file, specifically pointed out that:

> "Comments relative to inadequacies in the accounting system, the internal accounting control and procedures for safeguarding securities are set forth in certified public accountants' supplementary report included with Part II of Answers to Financial Questionnaire."

Any person sufficiently interested in the operations of Blair to consult that document would have learned there what Foley claims was concealed.

The treatment of the letter met not only the regulatory requirements as to filing but also the standards of the accounting profession and of fair reporting which establish that it was not necessary or proper to include the Supplementary Report on a balance sheet (Tr. 2140-42). Auditors are frequently called upon to provide letters, often called reports on internal control, which analyze internal accounting procedures and suggest possible improvements to clients or governmental agencies. Auditors have a strict responsibility with reference to such reports because no matter how useful internal control letters may be to management and regulatory agencies, their "usefulness . . . to the general public is questionable." AICPA, *Statement on Auditing Standards* § 640.05. The evident reason for this conclusion is that "the auditor's evaluation of internal accounting control is only an intermediate step in forming the opinion he expresses on such statements." *Id.* § 640.06.

Thus, the standards of the profession establish that internal control reports are tools to be used by management and the regulatory agencies to improve recordkeeping procedures. Nothing requires that such a letter be appended to a balance sheet, which is "a tabular statement or summary of balances (debits and credits) carried forward after an actual or constructive closing of books of account. . . ." Accounting Terminology Bulletin No. 1 ¶ 21. A balance sheet necessarily speaks of one moment in time, and it does not present facts relative to the efficiency of the concern or its methods of operations. Moreover, the AICPA concludes that "[i]n no event, should an auditor authorize a report on his evaluation of internal accounting control to be issued to the general public in a document that includes unaudited financial statements." § 640.11.

Moreover, Foley knew that Blair had converted from the ACS system of accounting and recordkeeping to the Midwest System on a date subsequent to September 26, 1969

(JA 53). This conversion, begun in November, 1969, made the inadequacy reported by Arthur Young as of September 26, 1969 immaterial. *See, e.g., Fischer* v. *New York Stock Exchange, supra*, 408 F.Supp. at 754. It was an inadequacy in a system that had been discarded. There were new problems, but Foley was aware of the difficulties Blair was encountering with the new Midwest System. Feldman had been told that Blair had charged off $900,000 to profit and loss as a result of unreconciled stock record differences and research and reconciliation had produced a recovery of $500,000 (JA 1054-56). These facts gave Foley an accurate picture of Blair's operational difficulties. If Foley were truly interested in each detail of this situation he would have inquired further and been told of that detail by Blair.

The Arthur Young financial statement which Foley received (E 2-3) disclosed that more detailed information about Blair's financial condition was to be found in Answers to Financial Questionnaire and that the published statement of financial condition was derived from statements of both the Blair division and the Schwabacher division. It is difficult to believe that Foley or Feldman would not have reviewed the Answers to Financial Questionnaire for the Blair division if Foley were truly interested in additional details concerning Blair's operational condition. Had he done so, the publicly available information would have revealed that Arthur Young had reported on Part I of the Blair division Answers to Financial Questionnaire that the Supplementary Report was included with Part II of Answers to Financial Questionnaire (E 155). The content of these comments, even though placed in a non-public file in accordance with the rules of the Securities and Exchange Commission, could have been obtained from Blair if Foley had placed any importance upon the additional details concerning Blair's operations which were revealed therein.

Of course, the Exchange, which was not a party to any of the negotiating sessions between Fol y (and/or Feld-

man) and Blair, had every right to assume that Foley obtained whatever he believed material from Blair and that Blair disclosed whatever was material.

III

The Exchange Did Not Act With Any Intent to Deceive

An additional reason given by the District Court in directing a verdict for the Exchange was that plaintiffs did not establish that the Exchange knowingly and intentionally defrauded them (JA 1008). There was no evidence to show that the Exchange acted with the "guilty knowledge" or "scienter" which must be shown, that is, intent to defraud or knowing use of a device, scheme or artifice to defraud. Moreover, there was no evidence that persons at Blair or Arthur Young acted with any intent to deceive. The Supreme Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 (1976), made the following statement:

> "We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud. 421 U.S. 909 (1975). We conclude that it will not and therefore we reverse." (footnotes omitted)

The Supreme Court emphasized the need to plead and prove "scienter" with the following statement:

> "When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct." (425 U.S. at 214) (footnote omitted)

When this standard is applied to the conduct of the Exchange, all claims based upon Rule 10b-5 fail.

This Court's opinion in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973), also establishes that no defendant may be held liable under Rule 10b-5 unless the plaintiff can prove either actual knowledge of misrepresentations and omissions or "willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge." *Accord, Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973).

The undisputed evidence was that the Exchange did not know of the alleged fraudulent misrepresentations and omissions in the discussions between representatives of Blair and Foley. Even though the Exchange knew that Foley was negotiating with Blair and did contribute capital to Blair on April 3, 1970, knowledge that the transaction occurred and approval of the moral and ethical qualifications of capital contributors and the form of the agreements to be used does not constitute knowledge or encouragement of fraudulent conduct. *Murphy* v. *McDonnell & Co., supra,* ¶ 96,021 at 91,588. The Exchange never encouraged Blair to make any fraudulent statements or omissions. The Exchange, in the absence of any knowledge or encouragement of the fraud alleged, cannot be held liable after *Ernst & Ernst* v. *Hochfelder.* As the District Court here found:

> "They [the Exchange] had every right to assume that the firm itself would have disclosed to him all business facts normal to such a transaction and had even more right, it seems to me, to assume that Mr. Foley himself, in making so large an investment as $2.5 million in a firm which he admits he knew was having business troubles, when every person reading the newspapers and paying any attention to the affairs of the Stock Exchange at that time knew that there were serious problems facing Stock Exchange firms, would have asked for the necessary information." (JA 1008)

Plaintiffs argue (Br. 11) that the Exchange was guided by an improper motive because any new capital for Blair would "lessen the potential exposure to the Exchange's Special Trust Fund which had been established to reimburse customers for losses sustained as a result of a member firm's operations." A similar argument was rejected by this Court in *Hirsch* v. *duPont, supra,* ¶ 96,011 at 91,544 n.8. This Court, acknowledging that the assistance program of the Special Trust Fund was entirely voluntary, stated:

> "Beyond the pecuniary interest, the Exchange had every reason to fear the collapse of a giant like duPont would lead to other failures, thus threatening the continued existence of the securities industry in its present form. But, of course, this concern hardly deviates from what might reasonably be supposed to be the interest of the investing public." (¶ 96,011 at 91,544)

The Court in *Hirsch* stated that

> "if a fraud was perpetrated on the appellants, the Exchange was unaware of it. We do not believe that the scienter required for rule 10b-5 aider-abettor liability, *see Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976); *Lanza* v. *Drexel,* 479 F.2d 1277 (2d Cir. 1973) (en banc) is present where, as here, the defendant entertains a reasonable belief that 'all the facts' have been fully disclosed." (¶ 96,011 at 91,544)

Similarly, in *Murphy* v. *McDonnell & Co., supra,* ¶ 96,021 at 91,588, this Court held that

> "contrary to the situation in *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972), it has no duty to come forward, *sua sponte,* with notes of warning to sophisticated lenders who have not sought its advice. Finally, we have 'serious doubt' *see Arneil* v. *Ramsey,* [Fed.Sec.L.Rep. ¶ 95,865 at 91,183 n.11 (2nd Cir. Feb. 16, 1977)], whether th *scienter* requirement

of Rule 10b-5, *see Ernst & Ernst* v. *Hochfelder*, [425 U.S. 185 (1976),] would be satisfied merely by the failure of the Exchange to disclose the results of its investigations when it is not asked for advice or for disclosure of the financial condition of the particular firm. *See Hirsch* v. *DuPont, supra.*"

IV

There is no Basis in the Pleadings or the Proof for a Controlling Person Claim Under Section 20(a) of the Exchange Act

The Exchange cannot be held liable as a controlling person of Blair under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).* The District Court, in dismissing this claim at the close of plaintiffs' case, referred to the "reasons set forth" in the Exchange's Supplemental Trial Memorandum (JA 1010-11). In that memorandum the Exchange argued that a claim under Section 20(a) was not before the Court since it had not been pleaded by the plaintiffs (JA 8-22) nor mentioned in their pre-trial order but was raised for the first time in plaintiffs' trial brief (Record on Appeal, Doc. 88). The Exchange's memorandum also argued that the claim was inconsistent with the statutory scheme established by the Exchange Act. This Court can affirm the District Court's dismissal of the Section 20(a) claim on any one or all of the grounds set forth in the Exchange's memorandum.

Plaintiffs, however, assert that the directed verdict was based upon the District Court's finding of "good faith" (Br. 31). That is incorrect. The Court's reference to "good faith" was part of its disposition of the Section 10(b) claim.

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* Plaintiffs also rely on Section 15 of the Securities Act of 1933. That provision applies only to persons who control "any person liable under section 11 or 12" of the Securities Act of 1933. Since no claim is pleaded in the amended complaint under the Securities Act of 1933, there can be no claim under Section 15 against the Exchange.

While it is a defense to liability under Section 20(a) to show that "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action", and we submit that the jury could only have concluded that this defense had been established, we also submit that the Section 20(a) claim was properly dismissed as contrary to the objectives of Section 6.

The first decision to consider such a theory of liability in respect to a national securities exchange was *Hughes* v. *Dempsey-Tegeler & Co.*, Fed.Sec.L.Rep. (CCH) ¶ 94,133 (C.D.Cal. 1973), *aff'd*, 534 F.2d 156 (9th Cir.), *cert. denied*, 97 S. Ct. 259 (1976). The district court's decision in *Hughes* found that the Exchange was not liable to a person who contributed capital to a member organization, but indicated that the Exchange could become a "controlling person" through conduct properly undertaken to fulfill the mandate of Section 6. The Exchange was not found liable as a controlling person of Dempsey-Tegeler, a former Exchange member organization, since the Exchange had fulfilled its regulatory obligations under Section 6 within its good faith discretion and had no knowledge of the misrepresentations or omissions of others. As the court stated,

> "The Exchange cannot be held accountable for that which it did not nurture, encourage, condone, sanction, or otherwise induce, and, although it must be deemed to have been a 'controlling person' under the circumstances, it could not be held liable for Walraven and Whitney's representations under this theory under either of the two Federal securities laws." (¶ 94,133 at 94,551)

Moreover, the court in *Hughes* recognized that the "very fulfillment of the affirmative section 6 duty by an exchange would seem to be totally inconsistent with participation in *any* conduct violative of [the Securities Exchange Act]." ¶ 94,133 at 94,552. Thus, even under the standard in *Hughes*,

there can be no liability to Foley under Section 20(a) since the jury found that the Exchange had fulfilled its Section 6 responsibilities.

Furthermore, the cases cited by the district court in *Hughes* provide no authority for its holding that a national securities exchange "controlled" its member firm for purposes of Section 20(a). In *Myzel* v. *Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), liability was imposed upon majority shareholders of a closed corporation for fraudulent representations to those who repurchased shares of the corporation for the ultimate benefit of the majority shareholders. In *Hecht* v. *Harris, Upham & Co.,* 430 F.2d 1202 (9th Cir. 1970), a brokerage firm was found liable under Section 20(a) for the actions of its representative in churning a customer's account. *See also Strong* v. *France,* 474 F.2d 747, 752 (9th Cir. 1973), and *SEC* v. *First Securities Co.,* 463 F.2d 981, 968-87 (7th Cir.), *cert. denied,* 409 U.S. 880 (1972).

On the plaintiff's appeal in *Hughes,* the Exchange argued that it is a misapplication of law and the policy of self-regulation to characterize the Exchange as a "controlling person" of a member organization by virtue of the Exchange's actions in pursuit of its Section 6 duty. The decision of the court of appeals, affirming, stated:

> "We similarly reject Hughes' arguments concerning the vicarious liability of Dempsey for its employees or the vicarious liability of the Exchange as a 'controlling person' of Dempsey. In our view, this is simply an inappropriate case for the 'fraud' provisions of the securities laws, even with their expansive interpretation." (534 F.2d at 177)

The controlling person claim was also considered and rejected by Judge Owen in his decision dismissing all fraud claims against the Exchange at the close of the plaintiffs' case in *Murphy* v. *McDonnell & Co.,* 71 Civ. 460

(S.D.N.Y. May 20, 1975), *aff'd on other grounds,* Fed.Sec.L. Rep. (CCH) ¶ 96,021 (2d Cir. April 14, 1977). Judge Owen held:

> "I must say I do not understand how it was arrived at, the determination [in the *Hughes* district court decision] of the controlled person. It seems to me a regulatory body is chargeable to the extent it has to be regulated and not under some other additional or lesser duty." (Trial transcript at 2350)

Thoughtful consideration was given to the application of Section 20(a) to the Exchange in *Carr* v. *New York Stock Exchange,* 414 F.Supp. 1292 (N.D.Cal. 1976). Judge Williams there rejected the analysis of Judge Lucas in the *Hughes* district court opinion. Judge Williams reviewed the purpose of Section 20(a) in the context of the self-regulatory system established by the Exchange Act and concluded:

> "Despite the broad reach given § 20(a) however, the purpose of the statute is misinterpreted if the direct or indirect control which forms the basis of liability is extended to the institutions created by the Act itself to regulate the securities markets. The present case is a clear example of the impossible Exchange position suggested by the plaintiff's interpretation of § 20(a). The Exchange is charged with a duty of regulating its member firms; the more closely it regulates, the more fully it becomes a 'controlling person', 'directly or indirectly' inducing the acts complained of, and the more susceptible to liability under § 20(a) it becomes. Morover, this liability would attach whether the Exchange took positive actions in furtherance of a fraudulent scheme, or merely failed to prevent a fraudulent scheme on the part of its member firms. Under § 20(a) mere good faith or lack of knowledge of the scheme is not enough to avoid liability. *Moscarelli* v. *Stamm,* 288 F.Supp. 453 (D.C.N.Y. 1968); *Myzel* v. *Fields, supra.*" (414 F.Supp. at 1302-03)

The Court in *Carr* dismissed the claims based on Section 20(a), stating:

> "A holding that a national securities exchange was a 'controlling person' for the purposes of § 20(a) would inhibit regulatory flexibility, would be contrary to the congressional intent in establishing the self-regulatory exchange system in the Act and would place the Exchange in an untenable position of strict liability for the fraudulent acts of brokerage houses and their employees." (414 F.Supp. at 1303)

The purpose of the controlling person statute is to provide a theory of liability under which those persons who have caused others to participate in unlawful activities can be liable. *See* H.R. Rep. No. 152, 73rd Cong., 1st Sess. 26 (1933) and 78 Cong. Rec. 8094-95 (1934). The "controlling persons" section was not intended to apply to the statutory relationship, set forth in Section 6 of the Exchange Act, between a registered national securities exchange, a self-regulatory body, and its member firms which were to be regulated. If Congress had intended the possibility of a national securities exchange "controlling" its members and thus assuming vicarious liability for the members' violations of the applicable sections of the Exchange Act, Congress knew how to, and would have, explicitly prescribed this potentially vast liability in the Act.

In *Lank* v. *New York Stock Exchange,* 548 F.2d 61 (2d Cir. 1977), and *Arneil* v. *Ramsey, supra,* this Court recognized that the interests of public investors and customers of brokerage firms may often clash with those of brokerage firms and their capital contributors. In order to insure the Exchange's undivided loyalty to public investors, member firms and their capital contributors were not permitted to assert a claim against the Exchange under Section 6 based on the Exchange's failure to enforce

its rules. In *Hirsch* v. *duPont, supra,* ¶ 96,011 at 91,545, this Court stated:

> "We will not undermine the achievement of this end by permitting a limited partner to recover under rule 10b-5 *solely* on the basis of an asserted violation of the Exchange's duty of self-regulation, where his recovery under § 6 would be precluded by our decision in *Arneil.*"

In *Murphy* v. *McDonnell & Co., supra,* ¶ 96,021 at 91,588, this Court declined to impose a duty to speak under Section 10(b) and Rule 10b-5 where it had found no such duty under Section 6. The Court stated:

> "If we imposed such a duty, the practical effect would be to require the Exchange to suspend a firm immediately upon finding it in default of the net capital rule. For the risk that liability might be imposed on the Exchange itself if the member firm made fraudulent representations in soliciting additional capital, *without the knowledge of the Exchange,* would be too great to allow the Exchange to suffer a delay that might enure to the benefit of the customers of the firm and to the stability of the financial community."

The legislative history shows that Congress wanted national securities exchanges to have the broadest discretion under Section 6. To impose "controlling person" liability for compliance with that congressional mandate would be contrary to the objectives of Section 6.

Conclusion

For the foregoing reasons, the judgment in favor of defendant-appellee New York Stock Exchange, Inc. should be affirmed with costs.

May 6, 1977

Respectfully submitted,

MILBANK, TWEED, HADLEY & MCCLOY
Attorneys for Defendant-Appellee
New York Stock Exchange, Inc.
1 Chase Manhattan Plaza
New York, N. Y. 10005

Of Counsel:

RUSSELL E. BROOKS
EDWARD J. REILLY
NORMAN R. NELSON

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May 6 1977
Hawkins, Delafield & Wood
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MAY [illegible]

LORD, DAY & LORD
ATTORNEYS FOR [illegible]